The New Markets Tax Credit Program

New tax credits

will level the

playing field for

investments in

low-income areas

nleashing the untapped economic potential of lowincome communities and marshalling their financial resources to revitalize impoverished urban and rural areas are the ambitious goals of a new federal tax credit program—New Markets Tax Credit (NMTC) now being implemented by the U.S. Treasury Department. The NMTC program is intended to stimulate \$15 billion in investments in economically distressed communities through the allocation and purchase of special tax credits.

The NMTC program is also intended to dispel certain longheld perceptions about low-

Ted M. Handel is of

counsel in the Los

Angeles office of

Loeb & Loeb LLP,

firm's Affordable

Housing Practice

Group.

where he leads the

income communities. One is that poor communities are risky areas in which to do business. Another is that low-income people cannot afford to pay for anything beyond the bare essentials of

life. Several studies suggest the opposite, that low-income communities are ripe for new businesses and investments. A national study on impoverished urban areas1 reveals:

More than \$85 billion in annual

retail spending—7 percent of all U.S. retail spending—comes from these areas.

- · Approximately one-quarter of this demand, or \$21 billion, is not being met by neighborhood retailers.
- Retail demand per inner city square mile is often two-to-six times greater than in each metropolitan-area square mile.

A report undertaken for and released by the Institute for Public Policy at Pepperdine University reaches much the same conclusion for the local South-Central Los Angeles area: "Compared with the rest of L.A. County, we find that South L.A., per capita, has 65 percent fewer grocery stores, 40 percent fewer banks and other financial institutions, and 20 percent fewer clothing stores. Most residents shop outside the area because many of the retail goods and services offered within the neighborhoods do not adequately meet the type of goods in demand. This is particularly true in the case of retail grocery goods....In a pre-

> vious RLA study conducted in 1995. residents in one targeted South L.A. area spent roughly \$1 billion in retail grocery goods. However, it was estimated that approximately \$412 million of this was

spent outside the targeted market area."2

It is the purpose of the NMTC to reconcile the needs of lowincome communities with the financial requirements of retailers, developers, and investors.

Stockton Williams, senior director of public policy for the Enterprise Foundation, explains, "Despite this extraordinary, largely untapped market opportunity, inadequate information and higher risks have made many financial institutions, investors and businesses reluctant to commit capital in distressed communities. Those that do invest demand higher rates of return than most investments will yield. The New Markets Tax Credit is designed to bridge that gap. By increasing the after-tax return to investors that provide equity capital, the NMTC will lower risk for investors and businesses, while cutting the cost of capital for community development groups trying to bring investment to their neighborhoods."3

Under the NMTC program, investors may claim a 39 percent credit over seven years (30 percent in present value) on their federal income tax liability for qualified investments.4 The credits will be apportioned at 5 percent per year for the first three years and 6 percent for each of the remaining four years.⁵ These investments must be made in forprofit organizations established to do business in low-income communities. By early 2003, \$2.5 billion in NMTCs will be allocated-\$1 billion in credits carried over from 2001 and \$1.5 billion in the 2002 statutory allocation. The remaining \$12.5 billion will be allocated over the next several years, ending in 2007.

NMTCs are designed to di-



rect investment capital solely to "low-income communities" and "low-income persons." Under the Internal Revenue Code, a lowincome community is one or more census tracts in which the poverty rate for each tract is at least 20 percent, or, for metropolitan areas, the median income does not exceed 80 percent of the greater of the statewide median income or the metropolitan-area median income. 6 Similarly, a low-income person is, for persons living in metropolitan areas, an individual whose income does not exceed the greater of 80 percent of the statewide median family income or 80 percent of the metropolitan-area median family income. Adjustments are made for an individual's income based on family size.

The Community Development Financial Institutions (CDFI) Fund in the Treasury Department manages the NMTC program. Congress created the CDFI in 1994 to expand the availability of credit, investment capital, and financial services in distressed urban and rural communities. The CDFI is responsible for certifying the organizations entitled to receive NMTC allocations and has established a competitive process for making the actual tax credit allocations to these organizations.

Both the Community Renewal Tax Credit Relief Act and the NMTC program were enacted as part of the appropriations bill for the Labor, Health and Human Services and Education Departments for fiscal year 2001.8 The NMTC and other legislative programs in the act represented a true bipartisan effort between the White House and Capitol Hill.

Community Development Entities

Community Development Entities, or CDEs, play a pivotal role in the NMTC program. With certain qualifications, CDEs are the only entities that may apply for NMTCs. CDEs are also the only entities that can receive an allocation of these tax credits and can direct how the proceeds from the sale of these credits to investors will be used. Any legal entity duly organized and validly existing under the laws of the state in which it is incorporated or established may qualify for CDE status. This includes a for-profit corporation or subsidiary of one, a nonprofit corporation or its affiliate, a partnership, or a limited liability company.9

Because the claimed NMTC is based on the amount of an investment—such as the purchase of stock or a capital interest in a partnership—only CDEs that are for-profit entities may actually receive an allocation of NMTCs. Consequently, nonprofit organizations involved in community development must form for-profit affiliates to receive tax credit allocations.

Regardless of the legal form, no organization may represent that it is a CDE until it has been certified by the CDFI. CDE certification requires passing two tests: the "primary mission" test and the "community accountability" test.10

The primary mission of the entity must be to promote community development. The entity's organizational documents (e.g., articles of incorporation, bylaws, annual reports) must clearly show that its purpose is to serve the needs of, or provide investment capital for, low-income communities or low-income persons. In addition, at least 60 percent of the products and services of the entity must be devoted to serving these communities or persons, such as investments in or loans to businesses or persons in these areas or financial support to organizations that promote community development.

The entity must also be accountable to the residents of its "service area." A service area may include a neighborhood, city, multiple cities, a state, a multistate area such as Appalachia, or even the nation as a whole. Accountability is satisfied by representation: At least 20 percent of the governing board of the entity or an advisory committee formed by the entity must include representatives of low-income communities within the service area. While the CDFI encourages CDE applicants to include low-income persons on the board or committee, this requirement may also be satisfied, for example, by representation from a business owner from these communities or a board member or staff person from an organization serving the area.

CDE certification is valid for 15 years unless revoked or terminated by the CDFI. A CDE must certify annually to the CDFI that it meets the primary-mission and servicearea requirements. By August 2002, the CDFI had certified 544 CDEs and, based on pending applications, the total could eventually exceed 1,000. Many applications are from nonprofit organizations seeking certification of for-profit entities. Local CDEs certified by the CDFI include the California Community Reinvestment Corporation, Community Commerce Bank, Century Community Development, Inc., Los Angeles Community Resources Financial Center, and the Inglewood Neighborhood Housing Services, Inc.

Century Community Development, Inc., an affiliate of Century Housing Corporation, intends to apply for an NMTC allocation. Century Housing is the successor nonprofit organization to a program established by the consent decree in Keith v. Volpe.11 Since 1979, Century Housing has met its judicial mandate of replacing low-income housing displaced by the Century Freeway by financing and/or developing 9,500 affordable units throughout Los Angeles. Century Community Development envisions using the proceeds received from investors to finance mixed development projects. These projects could comprise affordable housing financed with low-income housing tax credits and commercial projects backed by the sale of NMTCs. The proceeds may also be used to support nonprofit service providers, such as child care and educational organizations.

The CDFI issued a Notice of Allocation Availability in June 2002 and set August 29, 2002, as the deadline for submission of allocation applications. By that date, the CDFI had received more 350 applications from CDEs seeking \$25.8 billion in NMTC allocations-10 times the amount of credits available for this year. The CDFI is expected to announce its allocation decisions in early 2003.

Once the CDFI deems an applicant eligible and its application complete, the application is evaluated according to four criteria, each with a maximum of 25 points. There are also two bonus criteria worth an additional five points each.¹² The CDFI has indicated that the following is required for an applicant to score well:13

- Business investment strategy. A CDE must show that it will make loans or investments that meet the needs of underserved markets, are flexible or nontraditional, and are focused on customers who lack access to conventional sources of capital. A CDE also has to show a track record of investing in low-income communities and a readily identifiable set of business activities in which it will be involved between the allocation date and December 31, 2003, and a strategy for identifying other potential transactions in the future. A CDE must also describe the extent to which the entity will invest in unrelated businesses.
- Capitalization strategy. A CDE must demonstrate that it has secured commitments from investors or has a reasonable strategy of obtaining such commitments. The CDE must also show that its NMTC allocation request matches the level of investments that it expects to raise and the loans and equity that it will disburse. Consistent with one of the key reasons for enactment of the NMTC, a CDE has to show that it can leverage other sources of funding in addition to the cash that it will receive from NMTC investors. Finally, the CDE must indicate if it will invest the proceeds from investors that exceed the requirements of the "substantially all" test (described below).
- Management capacity. The CDFI will evaluate the experience of the CDE's management and staff in investing in low-income communities, raising capital (especially from for-profit investors), asset and risk manage-



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ment, and its history of complying with other federal programs, such as the program for low-income housing tax credits.

• Community impact. The CDFI will look at the involvement, if any, of low-income community representatives in the development and implementation of the CDE's investment strategy; the current activities of the CDE in these communities; the extent to which the CDE's investment strategy is consistent with federal, state and local development plans: the economic results that could not be achieved without NMTCs; and why those results could not be duplicated or enhanced through other sources.

The CDFI will also award up to five points to CDEs that satisfy each of two bonus criteria established by statute.14 The first criterion is a record by the CDE itself or an organization controlling the CDE of successfully providing capital or technical assistance to disadvantaged businesses and communities. The other five bonus points will be awarded to CDEs that demonstrate that they will make investments in businesses in which persons unrelated to the CDE hold a majority equity

The 2002 applications were initially reviewed and scored by three outside reviewers. CDFI staff are now evaluating the applications, and the CDFI will award allocations to the most qualified CDEs. The CDFI has not made any determination on the maximum amount of NMTCs that may be allocated to a given CDE. However, it is anticipated that the maximum allocation to a single CDE will not exceed \$100 million.

If a CDE receives an NMTC allocation, an allocation agreement will be entered into between the CDE and the CDFI. The terms and conditions of the agreement will include the amount of NMTCs allocated to the CDE, the approved uses of the allocation (e.g., loans or equity investments to qualified businesses or to other CDEs), the service areas in which the NMTC proceeds may be disbursed, the deadlines by when the CDE must have received investments, and reporting requirements. Nonprofit organizations that receive an allocation must also satisfy the CDFI that they control the for-profit subsidiary that will actually receive the NMTCs and that the nonprofit intends to transfer the allocation to that subsidiary.15

Qualified Low-Income Community Investments

Once the agreement is in place, a CDE may exchange its NMTCs for Qualified Equity Investments (QEI). A QEI may take the form of a purchase of stock (if the CDE is a corporation) or a capital interest (if the CDE is a partnership or limited liability company). 16 A CDE may receive only one form of consideration for a QEI-cash.17

An important feature of the NMTC program is the flexibility it affords a CDE in using its cash proceeds and structuring the terms and conditions of its investment in lowincome communities. Any investment that meets the legal requirements of a Qualified Low-Income Community Investment is acceptable. A QLICI can take several forms.

One form is an equity investment in, or loan to, a Qualified Active Low-Income Community Business.¹⁸ A QALICB is any corporation or partnership in which 1) at least 50 percent of the total gross income of the business comes from the active conduct of a qualified business in a low-income community, 2) at least 40 percent of the tangible property that the business owns or leases is located within a low-income community, and 3) at least 40 percent of its employees' services are performed in a low-income community.

Determining if a business meets the 50 percent gross income test is difficult if a business has offices, plants, and distribution centers both inside and outside low-income communities or if the business conducts some of its transactions, for example, over the Internet. In these situations, the IRS has indicated the requirement will be met if 50 percent of the business's tangible property is located within a low-income community or if 50 percent of the services it performs is by employees in a low-income community.¹⁹

The term "qualified business" also requires definition. Generally, a QALICB may engage in any trade or business with certain exclusions. Those exclusions include the rental of residential property or businesses that consist predominantly of the development or holding of intangibles; the operation of golf courses, country clubs, massage parlors, hot tub or tanning facilities; racetracks or other gambling facilities; liquor stores; or farming.20

Other types of QLICIs include:

- An investment in, or loan to, another CDE,²¹ in which the recipient CDE makes loans to a QALICB or provides financial counseling or other services to businesses in or residents of low-income communities.
- The purchase of a loan (but not investments) from another CDE if the loan is a QLICI.22
- Providing financial counseling and other services (i.e., advice on organizing or operating a business) to businesses located in, and residents of, a low-income community.²³

Regardless of what form the QLICI takes. the CDE must ensure that the investment meets the "substantially all" test,24 which may be met in one of two ways. The first is that at least 85 percent of the taxpayer's investment

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Mr. Gleitman has practiced sophisticated estate planning for 24 years, specializing for more than 12 years in offshore asset protection planning. He has had and continues to receive many referrals from major law firms and the Big Four. He has submitted 36 estate planning issues to the IRS for private letter ruling requests; the IRS has granted him favorable rulings on all 36 requests. Twenty-three of those rulings were on sophisticated asset protection planning strategies.

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must be directly traceable to a QLICI. This percentage is calculated by taking the aggregate cost basis in all QLICIs that are directly traceable to the taxpayer's cash investment and dividing it by the total amount of the taxpayer's investment. The other way to meet this test is through the "safe harbor" calculation, under which at least 85 percent of the aggregate gross assets of the CDE must be invested in QLICIs. This percentage is calculated by taking the CDE's aggregate cost basis in all its QLICIs and dividing it by the CDE's aggregate cost basis in all its assets.

This test must be met annually during the entire seven-year compliance period, and the test must be performed every six months. If a CDE makes loans and receives repayment of principal or equity, the substantially-all test will be considered to be met if the loan principal repayments are reinvested by the end of the next calendar year or equity payments are reinvested within 12 months.²⁵ Repayments of loan principal or equity received within the last year of the seven-year credit period do not have to be reinvested. This is also true for interest or dividend payments. Under the NMTC rules, up to 5 percent of the cash received for an investment may be held for loan loss reserves, and these proceeds can also be applied towards meeting the substantially-all test.

As with any provision in the IRC, there are many other rules that govern the conduct of a CDE and investors in these transactions. For example, a CDE must allocate its entire share of NMTCs within five years of the date of its allocation agreement.26 A CDE must also disburse within one year the cash it receives from an investor in exchange for an NMTC allocation.²⁷ For investors, NMTCs may only be claimed in an amount equal to the actual investment in the CDE and not the amount used by the CDE from the investment proceeds to buy a project or provide financial assistance to a business.²⁸ Also, the investor's basis is reduced by the NMTCs allocated to the investor.29

A CDE may use the 15 percent of its investment that is not dedicated to meeting the substantially-all test for other purposes, including broker fees, underwriter fees, issuance expenses, or cash reserves.

New Markets Tax Credit Deals

Investors may choose, as they already do under the low-income housing tax credit program, to invest directly in a CDE receiving an NMTC allocation or make their investment through funds that will purchase NMTCs from CDEs that have received allocations. Commercial banks may therefore become a significant investment source. KeyBank, for example, is marketing itself as a "one stop

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shop" for investments using NMTCs. To accomplish this, the bank qualified several related entities as CDEs and applied for an NMTC allocation of \$250 million. The bank has also formed several funds with an investment banking firm through which investor proceeds will be used to make mezzanine loans to QALICBs and purchase federal historic tax credits.

To illustrate how NMTCs could fit within a loan package offered by a bank like KeyBank, consider a QALICB needing \$10 million for a commercial development. The bank would make a conventional loan of \$7.5 million and a mezzanine loan of \$750,000 (30 percent of \$2.5 million). The mezzanine loan would be financed by cash that a KeyBankaffiliated CDE receives from the purchase of its NMTC allocation. Because of the tax savings realized by these investors from the NMTCs, the bank could charge the QALICB a lower interest rate on the mezzanine loan. An economic investor such as a high networth individual would then finance the balance. Although the QALICB would pay a higher interest rate to this investor, its overall debt service payments would be less because of the lower rate charged on the mezzanine loan.

The treasury secretary is authorized to issue regulations limiting "the credit for investments which are directly or indirectly subsidized by other Federal tax benefits."30 One subsidy specifically referenced was the low-income housing tax credit. However, in September 2002, the IRS issued a notice indicating that it would not apply limitations to historic rehabilitation tax credits, depreciation deductions, and tax benefits allocated to empowerment zones and enterprise communities.31 The IRS also said that it is continuing to review the limitation between NMTCs and low-income housing tax credits. For CDEs and investors, this notice is significant. It means, for example, that financing for a commercial development involving the restoration of a historic property could be eligible for both NMTCs and historic tax credits.

Apart from the risks perceived in investing in low-income communities, investors must also take into consideration the actual risk that NMTCs can be subject to recapture for seven years after an equity investment is made. Recapture may occur if 1) a CDE ceases to meet the CDFI's certification requirements, 2) the CDE fails to continuously use substantially all of a qualified equity investment, 3) the CDE redeems the qualified equity investment, or 4) the IRS finds that the principal purpose of a transaction is inconsistent with the purpose of the NMTC program.32 Bankruptcy of a CDE does not con-

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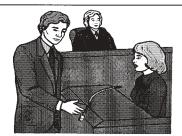
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In 2003, \$4 billion in NMTCs will be allocated by the CDFI-\$2.5 billion at the beginning of the year from the 2001 and 2002 allocations and eventually \$1.5 billion from this year's allocation. In 2004 and 2005, \$2.5 billion more will be allocated each year, followed by \$3 billion in both 2006 and 2007. If any credits remain unused after 2007, Congress has provided that the CDFI can allocate them until 2014.

The amount of NMTCs actually allocated by the CDFI will not determine the success or failure of this tax credit program; rather, its immediate future rests in the response of investors. A CDE's receipt of a NMTC allocation does not guarantee that investors will purchase stock or a capital interest in that CDE. Investors are expected to weigh many factors before deciding to make an investment. A significant factor will be whether or not the rate of return measures up to the risks associated with the CDE's proposed use of the investor's cash and if those risks will be mitigated through diversified investments. Other considerations will be the track record of the CDE or its sponsor, the qualifications of its management, and the procedures created by the CDE to ensure ongoing compliance with the requirements of the NMTC program. Investors will also take a hard look at the strategy proposed by the CDE for the investor to exit the entity after the seventh year and receive a return of its capital.

Investors will also look to maximize the tax benefits of NMTCs, especially if the IRS permits these credits to be leveraged. Leveraging is already an essential part of the NMTC program because CDEs are expected to build on the capital raised from the sale of NMTCs to attract other financing sources for investments.

Leveraging can also make NMTCs more attractive to investors. In a simple, straightforward NMTC transaction, an investor only receives tax credits based on the amount of cash that it pays for its investment in a CDE. By contrast, as an example of a leveraged transaction, an investment partnership could be formed in which the investor puts its money into the partnership and a bank makes a loan to the partnership and not the CDE. The investment partnership would invest the total proceeds received from the investor and the bank into a CDE. The investor would then receive NMTCs based on the total amount of the partnership's investment and not just its own funds. In this case, the rate of return to an investor could rise dramatically. As of early November 2002, the IRS was evaluating if NMTCs could be leveraged in this fashion and, if so, under what terms and conditions.

While these and other issues will need to be resolved, there are many reasons to be optimistic about investor response to the NMTC program. First, CDEs that succeed in the application process and receive allocations will most likely be those that developed programs in which investors have committed to buy NMTCs or expressed a strong interest

The experience of the Low-Income Housing Tax Credit program also provides a basis for optimism. When the LIHTC was created by the Tax Reform Act of 1986, many dismissed the notion that investors would be willing to purchase tax credits generated from the construction or rehabilitation of affordable housing. The IRS, investors, and housing developers also had to resolve many issues presented by the statute creating the LIHTC program. Sixteen years later, these issues have been largely resolved, the LIHTC is a permanent tax credit, and investors have demonstrated their confidence in the program by purchasing billions in credits.

Some observers believe the NMTC program is even more attractive than the lowincome housing program. The NMTC program has a shorter compliance period—7 years, compared to 15 years for LIHTCs. Another is that the exact stream of financial benefits can be calculated more readily; the flow of benefits is not dependent on when a building becomes occupied. Other perceived advantages include the absence of foreclosure risks and a reduced chance of tax credits being recaptured in a NMTC transaction.

Over the next seven years, the NMTC program will be successful if investors recognize that their investments are creating new business ventures that will tap the considerable economic potential of low-income communities and the people who reside in them. By doing so, the tax credits will not only provide these communities with needed jobs and services but also will eventually lead to their revitalization.

- ⁸ Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554
- ⁹ Guidance for Certification of Community Development Entities, New Markets Tax Credit Program, Notice, 66 Fed. Reg. 65806,65809 (Dec. 20, 2001).
- ¹⁰ I.R.C. §45D (c).
- 11 Keith v. Volpe, No. 72-355-HP (C.D. Cal. filed July 7, 1972). Under a consent decree, the Century Freeway Housing Program was mandated to replenish affordable housing stock depleted during construction of the Century Freeway.
- ¹² Notice of Allocation Availability Inviting Applications for the New Markets Tax Credit Program, 67 Fed. Reg. 40012, 40017 (June 11, 2002).
- 13 Id. at 40117-18.
- 14 I.R.C. §45(D) (f) (2).
- ¹⁵ Notice of Allocation Availability Inviting Applications for the New Markets Tax Credit Program, 67 Fed.

- Reg. 40012, 40016 (June 11, 2002).
- 16 I.R.C. §45D (b) (6).
- ¹⁷ I.R.C. §45D (b) (1) (A).
- 18 Treas. Reg. §1.45D-1T(d)(1)(i).
- 19 Treas. Reg. §1.45D-1T(d)(4)(A).
- ²⁰ Treas. Reg. §1.45D-1T(d) (5).
- ²¹ Treas. Reg. §1.45D-1T(d) (1) (iv).
- ²² Treas. Reg. §1.45D-1T(d)(1)(ii).
- 23 Treas. Reg. §1.45D-1T(d) (1) (iii). ²⁴ Treas. Reg. §1.45D-1T(c) (5).
- $^{25}\, Treas.$ Reg. $\S 1.45 D\text{-}1T(b)\,(1)$. ²⁶ Treas. Reg. §1.45D-1T(c) (4) (i) (A).
- $^{27}\, Treas.$ Reg. §1.45D-1T(c) (5) (iv).
- ²⁸ Treas. Reg. §1.45D-1T(b) (1).
- 29 I.R.C. §45D(h).
- 30 I.R.C. §45D(i)(1).
- 31 I.R.S. Notice 2002-64.
- 32 Treas. Reg. §1.45D-1T(e).

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¹ Initiative for a Competitive Inner City, Research Facts, available at http://www.icic.org/research/research

² Thomas Tseng, Common Paths: Connecting Metropolitan Growth to Inner-City Opportunities in South Los Angeles (May 1999), available at http://publicpolicy .pepperdine.edu/institute/RethinkingSouthLA/home .htm.

³ Stockton Williams, The New Markets Tax Credit: A Promising New Tool for Community Revitalization (Apr. 2001), available at http://www.frbsf.org /publications/community/investments/cra01-1 /newmarket.pdf.

⁴ I.R.C. §45D (a).

⁵ I.R.C. §45D (a) (2).

⁶ I.R.C. §45D(e).

⁷ Notice of Allocation Availability Inviting Applications for the New Markets Tax Credit Program, 67 Fed. Reg. 40012, 40013 (June 11, 2002).